Directorate of
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Mexico:
De la Madrid's Challenges

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An Intelligence Assessment

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ALA 82-10164
December 1982

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Mexico: De la Madrid's Challenges [redacted]

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An Intelligence Assessment

This assessment was prepared by [redacted] of the Office of African and Latin American Analysis. Comments and queries are welcome and may be addressed to the Chief, Middle America–Caribbean Division, ALA, [redacted]

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This paper was coordinated with the Directorate of Operations and the National Intelligence Council. [redacted]

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Preface

We are gravely concerned about the situation in Mexico. For the past 18 months, we have been tracking and regularly reporting on the serious financial deterioration. Over the past six months, we have witnessed unprecedented turmoil in the top ranks of Mexico's ruling party, the PRI, and in the government itself.

The most disturbing aspect of Mexico's problems is that they could lead to sudden and substantial changes in the political and social orders with little prior warning:

- Arguments within the PRI over appropriate paths out of the present quagmire could result in splits in the party and costly jockeying among factions.
- Growing concerns over endemic corruption, tolerated during the broad prosperity that accompanied the oil boom, could introduce a new divisive issue among the leadership and within society generally.
- A variety of unsettling conditions within Mexico could dry up access to foreign private credit, which is critical to Mexican recovery.

The Mexican left, divided for the moment, is well aware of these risks and will be preparing to exploit them.

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The purpose of this assessment is to provide a baseline for economic analysis and set a framework for understanding the political setting in which President de la Madrid must act, at least initially.

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Key Judgments

Information available as of 2 December 1982 was used in this report.

Mexico's economic crisis puts its political system at a crossroads, with dissidence coming from within and without the ruling Institutional Revolutionary Party (PRI). Heightened political pressures are expected to arise from an austerity strategy demanded by the International Monetary Fund (IMF), which is necessary to secure renewed foreign financial assistance and a return to economic growth. Such features of the program as higher peso prices for imports and reduced public spending will cause all elements of society to chafe. In charting a strategy to adhere to the IMF program, we believe President Miguel de la Madrid will be guided as much by the need to preserve and advance political consensus as he will by economic logic.

The strongest political pressures on the new administration will come from PRI-affiliated labor unions; for the near term, the unions appear supportive. Pressures from outside the party—especially if opposition leftists turn radical—will test the ruling group's ability to incorporate and co-opt disaffected elements without resorting to repression. While we believe Mexico's institutions are strong, they have not been buffeted before by the kind of prolonged crisis we envision. After five years of the oil boom, the churning and uncertainty associated with the new pressures could trigger serious social and political unrest.

In any event, maintaining the required austerity steps will probably be very difficult. We believe de la Madrid will be able to continue IMF-mandated interest and exchange policies despite complaints from domestic business. Holding the line on wages and subsidies will be more difficult, in part because the government has not clearly identified to Mexicans the extent that living standards will have to be lowered to bring the economy under control.

We believe that, even under the best of circumstances, the economy will contract next year. If Mexico manages to meet quarterly IMF targets, reschedules debt principal, and borrows another $5 billion in international capital markets, we believe—based on econometric modeling—that real GDP will still fall 2 percent, a result consistent with those of other forecasters. This relatively small dip in economic activity will entail lowered consumption, mounting bankruptcies, and soaring unemployment.

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Because the IMF program is the linchpin in Mexico's access to foreign credit, failure to adhere to it will entail serious difficulty in securing needed funds. We estimate that economic activity could fall as much as 10 percent if all new foreign credit were cut off.

Anticipating great pressures on de la Madrid and believing the chances of his wavering are significant, we place the odds at less than even that de la Madrid will meet all the IMF austerity targets through 1983. The result is likely to be halting readjustments to new IMF targets, with gaps in foreign funding and a decline in output of more than 2 percent but substantially less than 10 percent.

De la Madrid will want to keep Mexican-US relations on an even keel, but we think some grating episodes will be inevitable. Living with its offended dignity and cast in a mendicant's role, Mexico will be exceedingly sensitive and easily affronted. The temptation to shift the blame for its troubles to foreigners is likely to be irresistible, and the United States and the international banking community are obvious targets. Numerous bilateral conflicts such as those over immigration and trade seem likely to develop as various US interests become increasingly affected by the Mexican crisis.

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De la Madrid's Problems

His predecessor's failure to slow the economy in order to bring it in line with available resources bequeathed incoming President Miguel de la Madrid a dangerously unstable financial and economic situation that will heighten sociopolitical tensions.[1] Postponing an agreement with the IMF spurred capital flight and discouraged foreign bank loans, causing the economy to contract and inflation to skyrocket. As a result, we believe that the policy options now open to de la Madrid are narrow and politically hazardous. The now very severe correctives required to restore financial stability could tear at the very fabric of Mexico's socioeconomic system—a prospect underscored by the open disenchantment, anger, and frustration that prevails among Mexicans. We believe that criticism by opposition groups of official waste, corruption, and inefficiency, and the leftist parties' condemnation of the approach to the International Monetary Fund (IMF) as a sellout of Mexican sovereignty have diminished public confidence in the government. 25X1

President Miguel de la Madrid Sygma 25X1

De la Madrid's background and intelligence—and the talent around him—amply prepare him to tackle the technical aspects of the economic crisis, but this is not enough. During the presidential campaign he did not demonstrate, in the opinion of both the press and the US Embassy, the ability to inspire in the Mexican citizenry a sense of national purpose and pride. This psychological support will be essential to a successful economic program, particularly since the tangle facing Mexico will take considerable time to sort out. The elements of the problem—depleted foreign exchange reserves, $10 billion in deferred debt payments, and continuing capital flight—are far too serious for quick fixes. 25X1

IMF Letter of Intent

A mid-November preliminary accord with the IMF—a letter of intent—leaves much to be done. The accord specifies that it will be up to the new administration to put forward specific adjustment policies necessary to complete an agreed program before the IMF will extend any funds. As a result, further hard negotiations by de la Madrid may be needed before Mexico formally receives IMF support. 25X1

Even so, the letter of intent allows Mexico some financial respite. We believe that it will reassure foreign bankers and thereby free up most of the $1 billion still not disbursed on a $1.8 billion emergency loan mediated by the Bank for International Settlements in September. Also, because of the agreement, US bankers have extended the 90-day debt repayment moratorium—which would have ended on 23 November—for another 120 days. 25X1

Nevertheless, the Mexican Government has not made any progress on long-term debt rescheduling with foreign bankers. This lack of movement now saddles the de la Madrid administration with complex and tough financial negotiations. 25X1

[1] For a review of the causes of Mexico's recent economic declines, see appendix, "Backdrop to the Current Problem." 25X1

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The New Administration Faces Economic Reforms
De la Madrid exhibits confidence that he has the public support to undertake needed economic reforms. [redacted] he believes the record voter turnout in July—despite widespread discontent with government economic policies—demonstrated continuing support for the ruling party–government complex. [redacted] de la Madrid believes Mexico is in no danger of drifting into the kind of political turmoil that characterizes Central America. De la Madrid has a feel for the reins of power, having been in de facto control of the ruling party since early this year; according to US Embassy reports, he selected the legislative candidates for the national election and named the leaders of the Senate and the Chamber of Deputies, as well as a state governor. [redacted]

Even though de la Madrid's relationship with President Lopez Portillo was apparently strained—for example, he was not consulted about the bank nationalization—he was not completely shut out from the national decisionmaking process. His close associates are planning the 1983 budget and serving in key diplomatic slots. More importantly, his associates worked with the IMF negotiating team and approved the letter of intent. [redacted]

De la Madrid seems to temper his confidence with a realistic assessment of the tasks ahead. He told US Embassy officers that he realizes he must project strong leadership while implementing unpalatable policies, and commented that the first 100 days of his term would be crucial. Indeed, as indicators of his policies, the austere tone of his inaugural address and the technical and conservative background of key Cabinet officials may go some way toward establishing a national political consensus. [redacted]

De la Madrid's record and rhetoric as a campaigner suggest his desire to scour the inefficiencies and corruption out of the Mexican system. At the same time, we believe he wants to preserve the protective social and economic benefits that Mexicans have come to expect as their rights won in the "continuing revolution." The conflict between these goals will be apparent early in de la Madrid's presidency and is likely to be a theme throughout his six-year term. [redacted] 25X1

Early in 1982 de la Madrid had urged Lopez Portillo to cool the economy. By April, his advisers had worked out a 17-point austerity program patterned along IMF stabilization guidelines and were lobbying against currency exchange controls. During his campaign for the presidency, de la Madrid often spoke of the need for the government to increase efficiency to boost production and lower inflation. He also suggested that controls on prices and private investment should be scaled back. In his inaugural address, despite the call for austerity, de la Madrid also promised to increase social services, exempt the "most needy" from belt-tightening measures, and stated that he will do his best to guard against rising unemployment. [redacted] 25X1 25X1 25X1 25X1

We expect, therefore, that de la Madrid will compromise and so orchestrate the timing of the components of the austerity program as to minimize their impact on organized labor and the urban poor. This will dictate a slow economic stabilization process—doing only what is required to obtain and keep an IMF agreement. [redacted] 25X1 25X1

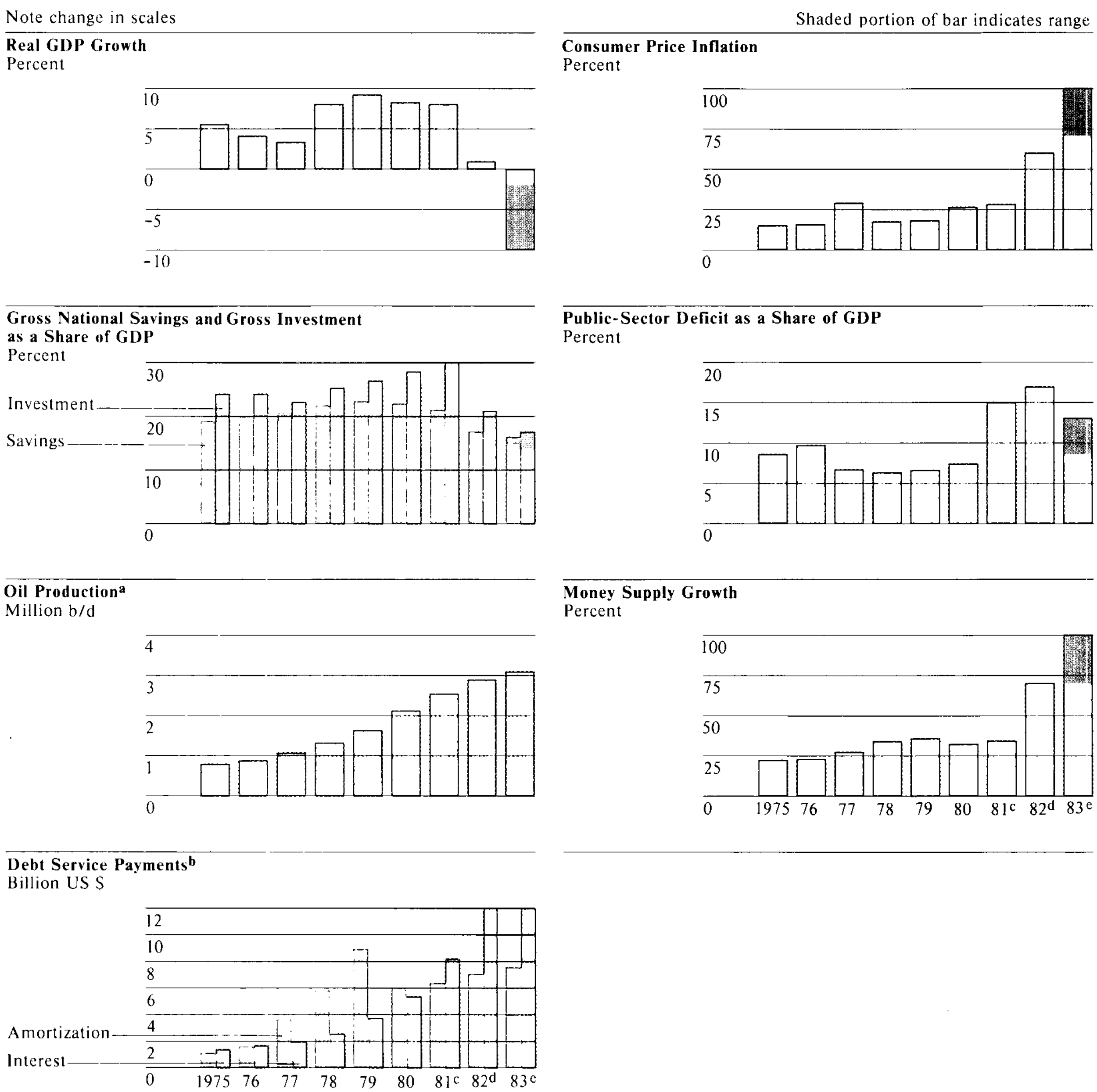
Nationalist and other political constraints are bound to limit the new administration in a variety of ways. [redacted] 25X1

Because Mexico's nationalized oil industry cannot allow the significant foreign participation necessary to boost oil production rapidly, output and exports are expected to rise just 200,000 b/d in 1983.[2] The resulting $2 billion increases in export earnings will ease but not redress the financial crisis. [redacted] 25X1

De la Madrid would also find it very difficult politically to boost export capacity by raising domestic prices to reduce internal consumption. Not only would this heighten opposition criticism of the government's inability to manage the national patrimony, but the consequent higher fares for public transportation 25X1

[redacted] 25X1

Mexico: Economic Indicators



[a] Including natural gas liquids.
[b] Interest on all debt, amortization on medium and long-term only.
[c] Estimated.
[d] Projected.
[e] Range, best case assumes Mexico successfully implements IMF program, worst case assumes Mexico loses IMF and international banking support.

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Policy Adjustments Required Under the IMF Package

Some specific policy adjustments have been announced now that de la Madrid has taken office. The letter of intent for the three-year IMF economic adjustment program makes clear that even more substantial changes are called for.

Government Spending Cuts. *The letter of intent requires Mexico City to slash government spending enough to cut the public-sector deficit to 8.5 of GDP percent next year—from about 17 percent in 1982. To get to 8.5 percent of GDP, Mexico would have to boost revenues by cutting subsidies 50 percent, cut other government spending 21 percent, or, more likely, some combination of the two actions such as a 15-percent cut in both subsidies and other government spending. We believe this will affect both federal employment and price subsidies on food, fuels, and other goods and services which amounted to $30 billion in each of the last two years.*

Price Controls. *The IMF agreed to flexibility in administering price controls, with a view toward allowing reasonable profit margins and maintaining production and employment. Heavy lobbying from labor and de la Madrid's promise to watch out for the needy will almost surely keep controls on many basic foods. Even though fuel prices were raised shortly after the inauguration, more price hikes are anticipated. The prices of some politically sensitive items such as tortillas and subway fares will still have to be increased substantially.*

Exchange Rate, Trade, and Interest Policies. *The tentative agreement calls for eventually abandoning the multiple exchange system, taking restrictions off foreign trade, and raising interest rates to positive levels in real terms. Because this will seriously worsen rampant inflation and bankrupt many inefficient firms, we believe de la Madrid will move slowly to free the peso, eliminate import controls and export subsidies, and realign interest rates.*

Wage Restraints. *Although the letter of intent left wage policy vague, it implicitly calls for sharp real cuts to lower consumption. Although de la Madrid has stated that he would allow wage increases that reflect improved productivity, organized labor thus far has not indicated that it will go along.*

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would be likely to provoke violence similar to the spontaneous street disturbances that occurred following a 2-peso (US 8 cents) increase in some Mexico City bus fares last year.

The Economy in 1983—Alternate Scenarios

What de la Madrid faces—belt tightening and accommodating what will look to the public like punitive demands from Mexico's creditors—would be difficult at any time, but it is made particularly objectionable to Mexicans following the good years of the oil boom. Securing and holding IMF support will be a bitter pill, but we assume that de la Madrid sees clearly that not coming to final terms with the IMF is really not a choice. As we detail below, we believe that the only plausible scenarios for economic performance in 1983 entail declines in real output and, accordingly, steeper declines in individual incomes. 25X1

None of the required austerity steps will be easy to maintain, and de la Madrid's ability to resist pressures by various interest groups will probably become progressively weaker. Anticipating great pressures on him, and believing the chances of his wavering are significant, we place the odds at less than even that de 25X1 la Madrid can sustain the initial austerity program through 1983. Mexican interest groups—including labor, business, and the middle class—will be scrambling to maintain their consumption levels. We believe that despite complaints from domestic business, de la Madrid will be able to continue IMF-mandated interest and exchange policies, in part because the private sector lacks the ability to bring direct pressure on the government. Holding the line on wages and subsidies, however, will be harder because labor is the largest and best organized element in the ruling party. [redacted] 25X1

Complicating his problems at home, international financiers have reported that they will refuse to reopen credit lines or provide new money unless de la Madrid implements and sustains austerity. We believe the falling consumption, mounting business failures, and unemployment that are likely to result could trigger serious social unrest. De la Madrid has an effective security apparatus that could contain public disorders if they develop, but at this point we have no feel for his inclination to use it. [redacted] 25X1

To establish some sense of the most likely course of the economy within these constraints, we made use of both Mexican projections and several US econometric forecasts.[3] We analyzed the domestic and international results of sustaining and not sustaining IMF support over the year. The salient difference in these scenarios was real economic decline of 2 percent (GDP basis) in the first case and 10 percent in the second. Because of the high probability that we see of Mexico's meeting some but not all of its IMF targets, we then considered a most likely path of performance. [redacted] 25X1

The Best Case. Under the best of circumstances, our analysis indicates that the economy will continue to deteriorate next year. We assume in this scenario that de la Madrid is able to meet whatever quarterly economic performance targets the IMF requires, that foreign bankers reschedule Mexico's debt principal obligations, and that the bankers provide $5 billion in new loans. This level of new lending would be just adequate to hold Mexican imports at their low 1982

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[3] CIA's methodology and a discussion of other econometric forecasts is detailed in appendix B. [redacted] 25X1

Table 1
Impact of Economic Deterioration

	Best Case	Deeper Crisis
Change in GDP (*percent*)	−2	−10
Unemployment expansion	1,200,000	2,000,000
Inflation (*percent*)	70	100
Change in real merchandise imports (*percent*)	NEGL	−25
Decline in supplies of locally available goods and services (GDP plus exports minus imports) (*percent*)	−4	−17
Change in investment (*percent*)	−14	−35
Change in per capita consumption (*percent*)	−5	−12
Current account balance (*billion US $*)	−3.5	+3.5
Exchange rate, pesos per US dollar (*yearend*) [a]	120-170	140-200

[a] Assumes 1982 yearend rate between 70 and 100 to the dollar, and that de la Madrid adopts the policy of adjusting the peso to compensate for the differences in internal and external inflation during 1983.

[redacted]

level, as long as capital flight is curtailed. As austerity takes hold in this scenario, industrial production and aggregate consumer supplies fall, inflation stays at 70 percent, and unemployment rises sharply. [redacted]

In the best case, Mexico could forestall another precipitous decline in imports. With an IMF accord, Mexico would be able to establish sufficient confidence to attract new foreign loans and end capital flight. Bankers have privately told US officials that once Mexico has implemented an IMF stabilization program, they would reschedule $27 billion in short- and long-term debt principal obligations, and would provide an additional $5 billion in new loans necessary to keep imports from falling. Assuming some global economic recovery, Mexico would also be able to increase export earnings by $3 billion—including $2 billion in higher oil sales. IMF drawings of just over $1 billion next year would be needed to repay emergency central bank swaps already taken as a bridge to the IMF loan, rather than financing new imports. [redacted] 25X1

We project, in this case, that economic activity would fall by 2 percent next year as lower investment and shortages of critical imported inputs cause industrial plants to close or cut shifts. Moreover, spending restraints would cut government purchases of equipment and machinery by as much as 20 percent, while government construction would fall by 10 percent [redacted] 25X1

Under these circumstances, the rate of decline in private-sector business activity would accelerate as the private sector's difficulty in foreign borrowing caused depleted inventories and critical import shortages. Public-sector borrowing, higher nominal wages, and local currency requirements for foreign debt servicing obligation would further reduce private imports of raw materials and capital goods from already depressed levels. Bankruptcies would mount, and many firms would have to reorganize to survive. Construction, manufacturing, commerce, and government services would be hard hit, while only the minerals sector—led by a 10-percent increase in petroleum production and related activities—would show any significant expansion. [redacted] 25X1

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As a result, unemployment would rise. The number of positions outside traditional agriculture would fall substantially, and a million new workers would be entering the labor force. Because of the lack of unemployment insurance or other benefits, we would expect many of those who lose industrial, construction, or government jobs to look for new sources of income in lower productivity artisan fields or personal services. Considering the fall in labor productivity, we determine that 100,000 jobs would be lost with each percentage point drop in economic activity.[4] Thus, unemployment would grow by some 1.2 million in 1983. [redacted] 25X1

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Despite growing austerity, in this scenario we calculate that inflation would increase by about 10 percentage points to about 70 percent on an annual basis. A large component in price increases would continue to be the soaring peso costs of imports. Prices of many foods, fuels, and other basic consumer goods would

[4] See appendix B. [redacted] 25X1

Table 2
Mexico: Foreign Financing Gap

Million US $

	1975	1980	1981 [a]	1982 [b]	1983 Best Case [c]	1983 Deepening Crisis [d]
Trade balance	−3,119	−1,647	−3,520	6,500	8,500	14,500
Exports, f.o.b.	3,461	16,925	20,880	21,500	24,500	24,500
Oil and gas	460	10,306	14,400	15,000	17,000	17,000
Manufactures	1,763	3,725	3,750	4,000	4,600	4,600
Agriculture	815	1,544	1,530	1,500	1,700	1,700
Minerals	423	1,350	1,200	1,000	1,200	1,200
Imports, f.o.b.	6,580	18,572	24,400	15,000	16,000	10,000
Net services and transfers	−574	−4,950	−9,480	−12,500	−12,000	−11,000
Interest	−1,437	−5,380	−8,217	−11,900	−12,000	−12,000
Current account balance	−3,693	−6,597	−13,000	−6,000	−3,500	3,500
Debt amortization	−1,058	−5,984	−6,310	−7,000	−7,500	−7,500
Financial gap	**−4,751**	**−12,581**	**−19,810**	**−13,000**	**−10,000**	**−4,000**
Medium- and long-term capital inflows	5,629	12,460	18,514	13,000	10,000 [e]	6,000 [e]
Net short-term capital (errors and omissions)	−740	1,009	2,396	−2,000	NEGL	−2,000
Changes in reserves	138	888	1,100	−2,000	NEGL	NEGL
Other financial items						
External debt (at yearend)	17,600	48,800	74,900	82,500	85,000	80,000
Short term	5,200	16,900	21,900	24,000	23,000	21,000
Debt service ratio (*percent*)	35.0	45.4	47.5	58.6	53.0	53.0

[a] Estimated.
[b] Projected.
[c] Assumes Mexico implements IMF program.
[d] Assumes Mexico loses IMF and international banking support.
[e] Includes $6 billion in debt relief on medium- and long-term debt principal due.

[redacted] 25X1

more than double as de la Madrid backed away from price controls and subsidies to meet the terms of the IMF agreement. Even with cuts in government spending, Mexico would still have to finance the $15 billion budget deficit (equal to 8.5 percent of GDP) in large part by domestic borrowing. Moreover, we expect that locally available supplies of consumer goods would fall 4 percent as GDP declined and exports increased. [redacted]

A Worst Case. If de la Madrid is unable to work out an IMF agreement and reschedule debt, econometric analysis by CIA analysts and others shows that the economy would go into a tailspin. [redacted]

[redacted] many international bankers—who have already indicated their concern over bank portfolios—would quickly move to reduce exposure to Mexico by cutting credit lines and calling in debt obligations. [redacted]

Mexico's inability to repay would cause financial chaos and, we believe, would lead to another surge in capital flight and a general default situation. If rescheduling efforts fell apart, foreign bankers would begin foreclosing on Mexican loans and seizing Mexican assets. While we judge that many bankers would

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seek to avoid further chaos by working hard to set up another short-term (six to 12 month) debt repayment moratorium, the economy would be severely damaged. [redacted]

Financial confusion would cut imports to the bare bone. The second consecutive year of import cuts would further slash investment and the availability of raw materials and reduce economic output by 10 percent. In this case, construction activities would virtually come to a halt, while manufacturing and normal commercial activities would tumble into a steep decline. Unemployment would jump by about 2 million—a net reduction of 1 million in employed workers and another 1 million in new jobseekers. [redacted]

In this scenario, commodity shortages would become critical, not only in lowering production but also in adding to inflationary pressures. Aggregate supplies (GDP minus exports plus imports) would plunge 17 percent and per capita consumption would fall by 12 percent. Under these circumstances, we would expect mounting political pressures on de la Madrid to take drastic steps in an effort to stem the plunge in consumption. Possible steps he could consider include unilateral debt repudiation, expropriation of foreign holdings in Mexico, further nationalization of private-sector businesses, and expansion of ties with the Organization of Petroleum Exporting Countries (OPEC) in exchange for Saudi Arabian financial support. [redacted]

The Most Likely Course. We expect that Mexican economic performance will fall somewhere between the two extreme cases examined above, but probably much closer to the minus-2-percent scenario. We believe de la Madrid is likely to be able to arrange IMF support and reschedule debt during his first months in office. The needed adjustments are severe, however, and de la Madrid is likely to fail to meet some of the quarterly IMF austerity targets. As a result, we expect to see halting steps, missed targets, and a variety of policy initiatives to satisfy both Mexicans and the foreign financial community. [redacted]

In this scenario, we see the makings of recurrent financial crises followed by further adaptation. During 1983, we believe the Mexican Government will probably be unable to cut public spending and subsidies enough to satisfy the IMF, if for no other reasons than the magnitude and complexity of the targeted changes. Other missed targets will probably include 25X1 excess expansion of domestic credit to state enterprises and the private sector. [redacted] 25X1 [redacted] we believe that these shortfalls 25X1 would cause foreign bankers to hesitate—creating occasional gaps in foreign funding—while Mexico and the IMF renegotiated. [redacted] 25X1

Still, under these circumstances we expect that the IMF and international bankers would go out of their way to respond to good-faith Mexican policy adjustments when they took place. As a result, imports 25X1 would fall only somewhat below the 1982 level; accordingly, investment and consumption would be less than under the best case scenario but nowhere near as depressed as under the worst case. [redacted] 25X1

Political Implications of Implementing Austerity

In our judgment, the economic crisis puts Mexico's political system at a crossroads. We believe the key to political pressures on the regime through 1983 will be the austerity program. Such features of the program as higher peso prices for imports and reduced public spending will cause all elements of society to chafe. In charting a strategy to maintain austerity and later to rekindle economic growth, de la Madrid will be guided as much by considerations of how best to preserve and advance political consensus as he will by 25X1 economic logic. [redacted] 25X1

Dissidence will come from within and without the ruling Institutional Revolutionary Party (PRI) as the austerity program proceeds. The strongest pressures—and the most complicated to deal with—will come from inside the party, particularly from PRI-affiliated labor unions. Those from outside the party—especially if opposition leftists turn radical—will test the ruling group's ability to co-opt disaffected elements. While we believe Mexico's institutions are strong, they have not been buffeted before by the kind of prolonged crisis we envision. [redacted] 25X1

Indeed, the severity of the pressures and the unprecedented turmoil within the PRI toward the end of 1982 make it difficult for us and other observers to specify what shape political events are likely to take in de la Madrid's first year in office. There is as yet, for example, no clear political parallel to the economic scenarios detailed above. Some of the jockeying and conflict that takes place will be determined or strongly influenced by specific measures and adjustments in the austerity program yet to take place. Other aspects of continuing turmoil will be driven by factional perspectives on how the system is changing and interest groups are being buffeted. Because of the indeterminacy of political trends at this juncture, the following sections detail the relative strengths and concerns—rather than the strategies—of particular groups. [redacted]

Dealing With Labor. Keeping urban workers satisfied is likely to be de la Madrid's prime political consideration because unionized labor makes up the PRI's largest and best organized sector. Labor's support is essential for any meaningful austerity program. Workers, particularly in Mexico City, are capable of mounting embarrassing, even violent, antigovernment demonstrations. Moreover, failure to pacify labor could seriously jeopardize ruling party cohesion. [redacted]

Negotiations for an end-of-the-year minimum wage hike that keeps the lid on real wages are an immediate challenge and will set the tone of de la Madrid's relationship with the labor movement. These annual talks—between government, labor, and private-sector representatives—traditionally establish informal guidelines for wage settlements in the next year. Increases in real wages would spur inflation, complicate austerity programs, and increase bankruptcies. On the other hand, falling real wages would feed worker dissension and spur leftist efforts to create a labor-Communist alliance. To avoid confrontations with labor, de la Madrid will, we believe, offer such concessions as raising minimum wages twice instead of once a year in return for labor's agreement to keep the wage increases moderate. [redacted]

We believe PRI-affiliated union leaders, because of their stake in the system, want to go along with the government. As representatives of the majority of Mexican unionized labor, they are strongly interested in continued stability. Top labor leader Fidel Velazquez said a year ago that organized labor considers itself "co-responsible with the government for directing the destiny of this nation." [redacted] 25X1

Recent strikes by independent unions—including airline and university employees—indicate the potential for labor unrest, however. Wage increases and price controls, according to US Embassy reports, have so far enabled PRI-affiliated labor leaders to maintain general labor support for the government. Nevertheless, tensions generated by increased unemployment, inflation, and fears that a looming IMF agreement will hit workers disproportionately could damage rank-and-file discipline and spark wildcat strikes among both the PRI affiliates and the independents. 25X1
Under these circumstances, the government could use force to keep dissidence under control, but such repression would introduce another adverse and risky element into the crisis. [redacted] 25X1

Additionally, we believe that leftist efforts to take advantage of worker unrest will pose problems. The Communist-dominated Unified Socialist Party of Mexico (PSUM) and the Trotskyite-oriented Revolutionary Workers Party (PRT) have established publicly acknowledged front groups to channel opposition to government economic policies. While PSUM-sponsored demonstrations have attracted little support—only 15,000 participated in a rally in Mexico City in October—the potential for leftist gains will increase, in our view, as the economic crisis continues or deepens. [redacted] 25X1 25X1

The Middle Class and the Peasantry. The PRI's "popular sector"—amorphous and dominated by middle-echelon, white-collar workers and teachers—is relatively easily manipulated by the ruling party–government complex. The diverse interests of this group make it organizationally weak and it lacks a leader of Fidel Velazquez's stature. Unemployment, inflation, and cuts in subsidies, however, are bound to intensify dissension in these groups, the prime benefactors of the oil boom. [redacted] 25X1 25X1

Although clashes between landless peasants and property owners frequently occur, we believe rural unrest is unlikely to pose a major problem. The government has recently invested substantial sums in rural development and, although disadvantaged, peasants are still the PRI's least unruly element. Moreover, according to US Embassy reports, opposition leftist efforts to chip away at government control in rural areas by establishing political front groups do not appear to have met with success. [redacted]

Opposition Parties. The PRI's power monopoly is so strong that, barring a major fissure in its structure, other parties can do little beyond providing democratic ornamentation for the Mexican system. Opposition elements—as mandated by electoral reforms implemented during the late 1970s—control 25 percent of the seats in the national Chamber of Deputies, but no Senate seats, governorships, or Cabinet positions. According to US Embassy reports, there is no opposition representation in the state legislatures, and only 50 of the nation's 22,000 mayoral slots and fewer than 150 local council seats are in opposition hands. [redacted]

Nevertheless, we believe that economic mismanagement and the rough times ahead offer the opposition an unpredecented opportunity to expand its influence. According to US Embassy reports, some PRI leaders are concerned that the electoral reforms are providing the opposition with too great an opening. Such fears are likely to magnify as the opposition seeks to capitalize on widespread antipathy to the IMF. Public response to belt-tightening measures will in large part determine the path the government chooses. Mexico City may seek to appease the opposition with increased representation or it could turn to fraud and repression as the formula for continued control. [redacted]

The center-right National Action Party (PAN), is the nation's largest opposition force, but elections consistently show that the party lacks a broad popular base; its support is strongest among the middle to upper class and almost nonexistent among labor and the peasantry. Nevertheless, PRI leaders may find it politically useful to employ the relatively strong showing of the party's presidential candidate this summer to justify implementation of austerity programs—which PAN supports. [redacted]

Likewise, the opposition left, especially the Communist-dominated PSUM, provides little competition. The party performed poorly in July's election, winning less than 4 percent of the vote. One small Trotskyite group has recently terminated its electoral alliance with the PSUM. Moreover, the left has not been able to put aside factional differences to present the PRI with a common front. [redacted]

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Traditionally, leftists co-opted into the Mexican system shun violence. Prior to this year's election, a Socialist Party spokesman told US Embassy officers that newly implemented electoral reforms could provide an opening to greater democracy and that the registration of the Communist Party was itself an important example of this. [redacted]

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Business and the Military. Private business—very important to de la Madrid's success in carrying out an austerity program—strongly endorsed his selection as presidential candidate. Businessmen are disquieted by the intensifying economic crisis, but their response is muted by lack of unity. According to US Embassy reporting, some businessmen have met with de la Madrid while others have set up regional symposiums attacking government economic policies in an effort to influence the new administration's policy. We believe a large number of businessmen would welcome the fiscal stability inherent in an IMF-mandated austerity program, although their view would probably change if the program seems to fall hard on private enterprise and protects labor and government. [redacted]

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President de la Madrid and his administration must particularly take into account the interests of the Mexican military, and the relationship that makes it an essential cog in the ruling party and government machinery. If, however, the new administration is inept in handling the unfolding economic crisis, civilian-military relations could begin to change. While we do not believe the military could or would attempt to

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seize power on its own, it might lend its strength to dissatisfied civilian elements within the system for an illegal change of administration. [redacted]

Implications for the United States

De la Madrid will want to keep Mexican-US relations on an even keel, but we believe some grating episodes will be inevitable even under the best of circumstances. Living with its offended dignity and cast in a mendicant's role, Mexico will be more than usually sensitive and easily affronted. The temptation to shift the blame for its troubles to foreigners is likely to be irresistible, and the United States and the international banking community are obvious targets. Numerous bilateral conflicts seem likely to develop as US interests become increasingly affected by the Mexican crisis. [redacted]

Cuts in Mexican imports and per capita income will drop US exports to Mexico over the next few years substantially below the $17.8 billion level of 1981. We expect many Mexican citizens to try to maintain consumption by earning dollars during illegal work trips to the United States—the US Immigration and Naturalization Service already reports a large jump since August. Others will increase the production and trafficking of narcotics. [redacted]

Moreover, most US businesses operating in Mexico—the majority of the $7 billion US investment—will be in for harder times as a result of continuing currency depreciation and slower economic growth. Expected sharp increases in the price of industrial fuels and other intermediate goods could lower profits, particularly if the government fails to hold the line on wage settlements as well. On the other hand, US-owned assembly businesses along the border, which process goods for reexport to the United States, are likely to increase sales as long as the peso remains competitive and wage increases are kept low. [redacted]

The worse the economic slide and the more nationalistic the Mexican policy reaction, the more difficult US-Mexican relations will become. A temporary debt repudiation, for example, would severely shake many US banks and have potential grave implications for the international financial system. Expropriation of US firms could tie up US-Mexican trade because of mandatory US Congressional sanctions in such situations. Border problems would multiply, with illegal crossings reaching unprecedented levels, and the already serious problems in the closely intertwined border economies would severely worsen with widespread bankruptcies of US businesses. [redacted]

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A sense of government-to-government partnership will be difficult to sustain against what we anticipate will be a background of soured public opinion on both sides of the border. In Mexico—where, for historical reasons, resentment of the United States is never far below the surface—such issues as increased gas and oil sales to the United States will quicken sentiment against its northern neighbor. [redacted]

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Implications for Foreign Policy

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Over the short run, we expect de la Madrid to maintain Mexico's active role in international affairs although he has told US officials that he intends to avoid inflammatory public statements. The new President has publicly stated he will maintain close ties with Havana and Managua, and US Embassy reports indicate he will continue to support the "emancipation process" in Central America. According to press and US Embassy reports, de la Madrid is skeptical of the evidence of Cuban and Nicaraguan involvement in Central American insurgencies. We believe that de la Madrid may at any time attempt to offset domestic antipathy to austerity with new foreign policy initiatives. In keeping with his intention to adopt a lower political profile, however, the new President will, in our view, endeavor to avoid issues that could promote confrontation with Washington—such as the Franco-Mexican declaration on El Salvador—and concentrate on global issues in international forums. [redacted]

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Appendix A

Backdrop to the Current Problems

Economic development and consumption goals during the Lopez Portillo years brought enormous economic problems to Mexico and were a key element in the immediate financial crisis. Economic growth of 8.5 percent between 1977 and 1981 was achieved only by yearly record hikes in government spending and budget deficits and dizzying increases in foreign borrowing. [redacted]

[redacted] US Embassy reports and US bankers, indicate that international bankers lost confidence in Mexico by the end of 1981 as they analyzed the softening world oil market, Mexico's huge foreign debt, planned government spending, and inflation rates. By the beginning of 1982, after the previous year's current account deficit was announced at a record $11.7 billion (later adjusted to $13 billion), Mexicans, too, lost their nerve. Massive capital flight forced Mexico to devalue the peso by 40 percent in February 1982. Despite this, Lopez Portillo refused to lower his goals and sought to keep government spending, public-sector growth, and consumption high, in part to avoid a political backlash in an election year. [redacted]

Mexico's failure to deal resolutely with mounting problems led to another sharp devaluation in August, a boost in inflation to an 80-percent annual rate, and a severe liquidity crisis. Plagued by a near doubling in wages, a tripling in import and debt service costs, and many frozen prices, key private businesses are heading toward default and bankruptcy. [redacted]

Despite $3.8 billion in emergency credit lines, Mexico's financial and economic situation has worsened. Politically motivated policy initiatives undertaken in September—new exchange controls, bank nationalization, lower interest rates, and tax breaks—interrupted drawdowns of funds from emergency loans, cut trade finance lines, and slashed imports. Shortages of key imported raw materials and intermediate goods caused industrial production cuts. [redacted]

In these circumstances, Mexican Treasury officials indicate that GDP fell by about 3 percent during the period September through November, inflation jumped to 80 percent on an annual basis, and unemployment increased sharply. Moreover, Mexican officials further report that more than 400,000 jobs—largely in construction and manufacturing—were lost in recent months, especially in the key industrial states of Nuevo Leon, Veracruz, Mexico, Tabasco, and Coahuila. [redacted] 25X1

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As de la Madrid takes office, the key economic indicators are staggering in their portent:
- Mexico is essentially out of foreign reserves.
- Foreign debt exceeds $80 billion; more than $30 billion in principal on short- and long-term debt is due within a year.
- Debt service obligations on long-term debt alone total some $1.7 billion per month, or nearly 90 percent of merchandise exports.
- If short-term debt cannot be rescheduled, debt service obligations will double to about $3.5 billion per month.
- To avoid default and maintain essential imports, Mexico must reschedule debt principal payments and borrow at least another $0.5 billion per month. 25X1
- While Mexico is unable to borrow, its private debt arrearages are mounting (standing at perhaps $2 billion as of early December), and imports have been slashed. [redacted] 25X1

For 1982, we believe economic performance will be substantially worse than in 1981. Our econometric analysis of Mexican official statistics indicates that: 25X1
- Overall economic growth will probably be about 1 percent, compared with 8.1 percent last year.
- Supplies of locally available goods and services (GDP plus exports minus imports) will fall 4 percent compared with a 10-percent increase in 1981.
- Inflation, on a year-to-year basis, is likely to equal 60 percent, twice the rate last year.
- The public-sector deficit will be about 18 percent of Mexico's gross domestic product, compared to 15 percent in 1981. 25X1
- The current account deficit will be cut by more than half from $13 billion in 1981 to about $6 billion. [redacted]

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Policy Chronology—1982

January	Unprecedented current account deficit for 1981 announced ($11.7 billion, later revised to $13 billion).
February	Devaluation of peso from 26 to the dollar to 40 to the dollar.
	Price controls announced on 5,000 different consumer goods.
March	Emergency wage settlement implemented, averaging 25 percent.
April	Austerity program worked out.
May	Presale of oil announced to boost financial reserves.
July	De la Madrid elected.
August	Prices of tortillas and bread doubled, as subsidies reduced.
	Dual exchange rate announced. Preferential rate set at 50 pesos to the dollar. General rate fell to 120 pesos to the dollar by the end of the month.
	Banks closed and all foreign exchange trading suspended. Dollar accounts frozen.
	Banks reopened with a triple exchange rate system: a preferential rate, a rate for withdrawals from dollar accounts, and a general rate.
	Mexico begins negotiations with the IMF. Details of financial aid package with the United States and other central bankers announced.
	Price controls extended for 90 days. Tax breaks to aid private sector and a 35-percent reduction in personal income taxes announced.
	Ninety days debt moratorium with commercial bankers began.
September	Lopez Portillo nationalizes the banks and extends exchange controls.
	Dual exchange system reestablished with general rate pegged at 70 pesos to the dollar and preferential rate set at 50 pesos.
	New subsidized interest rates on commercial credits announced.
	Planned protest by Monterrey businessmen called off.

	Public-sector workers granted an average 7-percent wage hike.
October	Intense IMF negotiations break without letter of intent.
	Elements of organized labor threaten strikes.
November	Isolated strikes.
	Letter of intent signed with IMF.
	Constitution amended to legalize nationalization of the banking system.
	Debt moratorium with commercial banks extended 120 days.
	Banks discuss $1-1.5 billion in new credits.
December	De la Madrid inaugurated.
	Government, business, labor minimum wage negotiations scheduled.
	Gasoline prices doubled, interest rates raised.

Appendix B

Methodological Notes on Economic Forecasts for 1983

Economic projections for 1983 are derived from our analysis of official Mexican Government projections, recent forecasts published by major US econometric forecasting companies, and the application of an econometric model [redacted]

Econometric models have become conventional tools for analyzing market economies like Mexico's. In a system of equations, these models combine a theoretical representation of the economy, a statistical analysis of the key relationships, and assumptions about government policies and external events. The solution of the system of equations produces conditional estimates of the future; comparisons of separate runnings under different assumptions can be used to determine the sensitivity of the economy to alternative future conditions. [redacted]

Best Case Forecast

Using recent Mexican Treasury and Central Bank data and assuming that Mexico will be able to maintain IMF support, reschedule debt, and attract new loans, DRI, International Economic Analysis, Inc. (IEA), Wharton Forecasting Associates (WEFA), and CIA made estimates for Mexican economic performance in 1983 with very similar results. All the forecasts agree that GDP will fall by 2 or more percent. While IEA believes that deflation and slightly higher imports can reduce inflation, DRI and WEFA project that imports will not rise and inflation will stay at a little above 70 percent. Our results, using the DRI model under different assumptions indicate somewhat less economic contraction than the other estimators project. We reach the lower figure primarily because we believe labor will have a little more success in maintaining disposable income and that this will keep personal consumption (equivalent to 65 percent of GDP) slightly higher than other forecasters claim. The results of the econometric projections are shown in table 3. [redacted]

Table 3
Forecasts of Key Economic Variables

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	Changes in GDP *(percent)*	Inflation *(percent)*	Current Account Balance *(billion US $)*
Data Resources [a]	−2.8	74	−3.8
Wharton Econometric Forecasting [b]	−2.1	75	−3.9
International Economic Analysis [c]	−2.5	45	−5.6
Mexican Government	0	NA	−3.4
Central Intelligence Agency	−2	70	−3.5

[a] *Latin America Review,* fall 1982, Data Resources, Inc.
[b] *Latin America Outlook,* fall 1982, Wharton Econometric Forecasting Associates.
[c] *Latin America Economic Outlook,* September 1982, International Economic Analysis, Inc., in association with Evans Econometric, Inc.

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[redacted] 25X1

Worst Case Forecast

The worst case forecast in this paper assumes that international bankers abandon Mexico, and—without new loans—merchandise imports fall by one-third, thereby causing a sharp cut in economic activity. These assumptions, applied to the DRI model, yield a decline in GDP of 10 percent, inflation of 100 percent, and a current account in international payments in surplus. [redacted] 25X1

These results reflect the overwhelming importance of imports to the economy. Official Mexican statistics show that two-thirds of all investment in machinery and equipment in recent years was accounted for by imported capital goods. Imported industrial inputs, many of which are not locally available, make up almost one-fifth of all raw materials and intermediate

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goods used in Mexican industry. In this situation, the confusion caused by debt arrears and disrupted investment and planning would reduce investment spending below the level needed to replace wornout capital goods. Because of the deteriorating capital stock and reduced imported inputs, economic activity and employment would fall sharply. We believe that inflation would almost surely outpace wage hikes by a wide margin and personal consumption would also tumble sharply. [redacted] 25X1

Neither the Mexicans nor the major econometric services have published a detailed forecast on such a worst case. They only state that the fall in economic growth and the increase in inflation would be much worse if Mexico loses IMF support. We made assumptions about the magnitude of the drop in imports and investment for a worst case. Then, using economic theory and the DRI model, we investigated the implications for growth and inflation. [redacted] 25X1

Unemployment

The rise in unemployment specified in the body of the paper was derived from analysis of the following identity

$$P=0/L \qquad (1)$$

where P equals average labor product, 0 equals real GDP, and L equals employed workers. It follows from the equation that the percent change in economic activity is equal to the percent change in employment plus the percent change in labor productivity, or

$$0^*=L^* + P^* \qquad (2)$$

where * indicates percent changes. [redacted] 25X1

As indicated by equation (2), the decline in economic activity can be distributed among lower employment and lower labor productivity. Because of the lack of social services for the unemployed, we believe much of the decline will be accounted for by lower labor productivity. Many of those who lose modern sector jobs—including virtually all those who are their family's principal breadwinners—will scramble for new jobs in lower productivity artisan fields or personal services. As a result, we assume that only one-half of the decline in economic activity will be accounted for by net job losses, while the other half will be caused by lower labor productivity. Thus, for each 1-percent drop in GDP, one-half of a percent of those employed (100,000 out of the current 20 million) would become unemployed. [redacted] 25X1